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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
Implementation of the Non-	)	CC Docket No. 96-149
Accounting Safeguards of Sections	)	
271 and 272 of the Communications	)	
Act of 1934 as amended	)	
	)	
and	)	
	)	
Regulatory Treatment of LEC	)	
Provision of Interexchange	)	
Services Originating in the LEC's	)	
Local Exchange Area	)	

COMMENTS OF THE UNITED STATES TELEPHONE ASSOCIATION

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SUMMARY

The entry by the BOCs into the interLATA market is a new development made possible by the 1996 Act, and the Section 271/272 process should move forward, as Congress intended. But the FCC should not lose sight of the fact that the vast majority of USTA's members have always been free to enter the long distance market, and many have done so. These companies offer long distance service in a variety of ways -- as a reseller; as facilities-based competitors; and as competitive access providers. These carriers' participation in the market has served the public interest by providing consumers with additional long-distance options. There is no need to impose new regulations on these companies' long distance operations.

As demonstrated herein, and in the attached Statement of Professor Daniel Spulber, there is no need for the Commission to alter the market definition it has used since 1985 in assessing the market power of long-distance companies. The relevant product market is still "all interstate, domestic, interexchange telecommunications services" and the geographic market is nationwide. The Commission recently applied these market definitions in considering whether the largest interexchange carrier qualified for non-dominant treatment, and it should do so here. There is no "credible evidence" that there could be a "lack of competitive performance" which justifies a different geographic market definition.

The interexchange operations of Independent LECs do not have market power - they cannot raise the price of interexchange service by restraining their output of interexchange services. An Independent LEC cannot create or exercise market power in the long-distance market by "leveraging" its local exchange and exchange access facilities. The small size of the Independent LECs as compared to large, national interexchange carriers; the technological, market, and regulatory changes that are transforming local telecommunications, and the fundamental flaws in leveraging theories dispel these concerns.

Dominant carrier regulation, moreover, does nothing to address the potential concerns raised in the Notice. In fact, such regulation would simply impose burdens on the Independent LECs and their interexchange operations and inhibit their entry as new competitors in the interexchange market. Competitive options would be lost for consumers if Independent LECs elect not to enter the market because of regulatory burdens and disadvantages.

Additionally, where Independents do enter the market, dominant carrier regulation's attendant longer notice periods, and the requirement to reveal detailed cost and new services information would distort competition. Instead, the FCC should adopt the recommendation that USTA made in the pending Interexchange NPRM, and eliminate the separation requirements now imposed upon independent LECs as a condition for non-dominance.

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COMMENTS OF THE
UNITED STATES TELEPHONE ASSOCIATION

INTRODUCTION

The United States Telephone Association ("USTA") respectfully submits these comments in response to the Commission's *Notice of Proposed Rulemaking.*[1] USTA is the major trade association of the local exchange carrier ("LEC") industry, with over 1,000 members. USTA's present comments address the Commission's inquiry into whether the regulatory regime for non-dominant treatment of independent LEC long-distance operations should be altered. USTA attaches a statement from Professor Daniel F. Spulber of Northwestern University which sets forth in detail the economic basis for its conclusions. ("Statement of Professor Spulber").

Many USTA members offer long distance service in a variety of ways -- as a reseller; as facilities-based competitors; and as competitive access providers. USTA urges the FCC to consider the situation of these carriers thoughtfully and to find that there is no need to impose

[1] Notice of Proposed Rulemaking, CC Docket No. 96-149, FCC 96-308, released July 18, 1996.("Notice").

dominant regulations on these companies' long distance operations, nor to retain the structural safeguards now applicable to independent LECs.[2]

I. The Interexchange Telecommunications Market Is A National Market In Which Independent LECs Compete With National Interexchange Carriers

The Commission has asked whether it should revise its definition of the relevant geographic market to separately consider the geographic area where a LEC provides local service. It should not. In 1985, the FCC found that a national geographic market for interstate, interexchange telecommunications service was correct and appropriate "because of supply substitutability and low entry barriers."[3] The Commission observed that the nationwide network operated by AT&T extended to virtually every location served by other carriers, including the independent LECs. The reasons for a national geographic market are even more compelling than when the Commission first resolved this question. And there is no evidence suggesting a lack of competition in long-distance services within Independent LECs' service areas.

In its most recent decision to reclassify AT&T as "non-dominant," the Commission also examined the geographic market from a national perspective.[4] The national scope of major telecommunications companies has greatly increased, not lessened, in the intervening years. As the Commission is well aware, the long-distance arena is dominated by three large facilities-

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[2]Even any new regulations which apply to the BOCs are scheduled to sunset in 3 years in expectation of robust competition in both the local and long distance markets. See 47 U.S.C. § 272(f)(1). Given these expectations about competition, new regulations for Independents are particularly inappropriate.

[3] Competitive Carrier Proceeding, CC Docket No. 79-252 Fourth Report and Order, 95 FCC 2d 554 at 574-75 (1983), vacated, AT&T v. FCC, 978 F.2d 727 (D.C. Cir. 1992), cert. denied, MCI Telecom. Corp. v. AT&T, 113 S. Ct. 3020 (1993).

[4]See Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, Order, 11 FCC Rcd 3271 (1996)("AT&T Reclassification Order"), recon. pending.

based carriers, with a larger fourth carrier close behind.[5] While these carriers control over 85% of the market, Independent LEC long-distance operations have market shares which can only be characterized as extremely small. Their market share does not even register in the Commission's Industry Analysis Division study. The one exception, the long distance operations of the Frontier Corp., has an interexchange market share of less than 2%. See Statement Professor Spulber at 10.

A national market remains the relevant market for Independent LECs because that is the relevant market for their competitors -- and for the public. As discussed by Professor Spulber, the service offerings of the major competitors to Independent LEC interexchange offerings are ubiquitous, not local or regional - similarly, their pricing, marketing, and networks are all national in scope. To narrowly define markets by region or locality would misrepresent the extent of the competitive activities of the long distance carriers, present an inaccurate picture of the competitive alternatives, and thus distort the market power analysis. See Statement of Professor Spulber at 4-8. Consequently, the Commission should retain the national geographic market definition utilized in the Competitive Carrier Proceeding.[6]

[5]That carrier, LDDS WorldCom, recently announced a merger with MFS Telecommunications, Inc., a large competitive access provider, and corporate holding company for a large long-distance carrier in its own right, MFS Telenet, Inc. This merger is expected to yield a firm with a cumulative capitalization of $23 billion, revenues of $5.4 billion, and over 500,000 customers. WorldCom/MFS, combined with MFS' recent purchase of Internet provider UUNet, are expected to be a "major force" in telecommunications. See Wall Street Journal, August 26, 1996, at A3. Even so, revenues of $5.4 billion represent only about 14% of those of AT&T, the most common competitor with Independent LEC long-distance operations, and about half of MCI, according to FCC figures. See Statement of Daniel Spulber, Table 2, at 15.

[6]See Fourth Report and Order, 95 FCC 2d at 574-575.

II. The Notice Presents No Basis For Concluding That Independent LECs Possess or Could Exercise Market Power in the Interstate, Interexchange Services Market

The Commission cites no actual evidence of harm from Independent LEC participation in the interexchange market. This fact is extremely significant. Unlike the BOCs, which have been excluded from the relevant product market, the independent LECs have an established actual track record with regard to participation in the long distance market. The FCC can easily refer to the actual experience of independent LEC participation in the interstate long distance market to confirm that the independent LECs have not been able to exercise market power or discriminate against their competitors. See Notice, para. 146 (Commission notes that it has experienced few problems with independent LEC provision of interexchange services); Id., at n. 284. (No Independent LEC is mentioned in its list of complaint proceedings).

Among its mid-size company members, USTA understands that at least nine currently offer interstate long distance service: North Pittsburgh Telephone Company, Conestoga Telephone; Century Telephone; ALLTEL Corporation; Frontier Corporation; Horry Telephone Cooperative; Illinois Consolidated; Lufkin-Conroe; ATU Telecommunications; and TDS. Additionally, there are over 100 small telephone company members of USTA who provide long distance service.

These small companies provide a competitive long-distance alternative in such communities as Gozales, LA (East Ascension Telephone, Inc.); Aurora, NE (Hamilton Telecommunications); Metamora, IL (Metamora Tel. Co.); Sycamore, OH (Sycamore Tel. Co.); McMinnville, TN (Ben Lomand Rural Tel. Coop); Walnut, IA (Walnut Tel. Co.); and Tahoka, TX (Poka Lambro Tel. Coop, Inc.).

When it classified AT&T as non-dominant, the FCC found that supply and demand in the interexchange market were sufficiently elastic to constrain AT&T. Regarding demand elasticity, the Commission has found that both residential and business customers find the services provided by AT&T, and other long-distance providers, to be close substitutes, and will switch to or from AT&T in order to obtain price reductions and desired features. AT&T Reclassification Order, 11 FCC Rcd at 3305, para. 63. If this is true for AT&T, it is also true for the long-distance services of Independent LECs. Regarding supply elasticity, the Commission found it an undisputed fact that other carriers could absorb overnight as much as fifteen percent of AT&T's total 1993 switched demand at no incremental capacity cost. Id., at 3303, para. 58. If facilities exist to render supply elasticity sufficient to constrain the pricing decisions of a carrier with over 50% of market demand, supply elasticity must a fortiori be sufficient to constrain the pricing decisions of long-distance carriers with an infinitesimal share of market demand. See Statement of Professor Spulber, at 11-12. Thus, the FCC's own decisions demonstrate that any attempt by an Independent LEC to raise prices by restraining output of long-distance service would fail.

III. Independent LECs Cannot Exercise Market Power By "Leveraging" Their Local Exchange and Access Facilities

The core of the Commission's concerns continue to focus on the Incumbent LECs' theoretical ability to exercise market power through leveraging ownership of local exchange and access facilities, either through cross-subsidizing long-distance services with revenues from regulated local services, or by providing discriminatory interconnection. See Notice, para. 125. As explained by Professor Spulber, "leverage" is defined in antitrust law as the use of monopoly power in one market to extract additional monopoly rents and secure competitive advantages in a second market. As Professor Spulber explains, under the conditions prevailing in the telecommunications market, the "leveraging" scenario posited by the Notice is extremely implausible. Statement of Professor Spulber, at 35-38.

First, there is no incentive to engage in such leveraging because extending a hypothetical monopoly in local services into a second monopoly in long distance service produces no additional profits. Additionally, the leverage scenario is inconsistent with the incentives created by local competition and the Commission's Interconnection Order, which will make the network facilities owned by Independent LECs available to competitors at cost-based prices. Finally, existing regulations prevent any such leveraging.

A. Independent LECs Could Not Exercise Market Power Through Cross-Subsidizing Long-Distance Services With Local Exchange or Access Revenues

The Commission believes that separation requirements and/or dominant regulation may be needed to address the potential danger of anti-competitive behavior where an Independent LEC shifts costs to its regulated local exchange or access services (and thus raises the prices of those services) in order to increase the costs of its long-distance competitors (and thus force them to either raise prices or restrict output). Notice, para. 158. The Notice clarifies that the Commission is examining the cross-subsidy issue only insofar as it is relevant to market power - in the context of a predatory pricing strategy. Notice, para. 135.

LECs, and particularly Independent LECs, have no incentive to raise the price of access charges.[7] Raising the cost of access charges in an attempt to reduce a long-distance competitors' output of long-distance services reduces demand for access charges, thus creating no increase in overall revenue. See Statement of Professor Spulber, at 40. For an Independent LEC to engage in predatory pricing is particularly implausible, given the relative size of their multi-billion dollar interexchange competitors, and the amount of cross-subsidy which would be required to drive these carriers from the market.[8]

[7]As a general matter, Independent LECs receive a higher percentage of their revenues from access charges than do RBOCs. See "National Summaries of Rural Telephone Borrowers," Rural Utilities Service (1994 data shows that RUS borrowers obtain 67% of Net Operating Revenues from Network Access and Long Distance Service Revenues).

[8]Predatory pricing strategies by Independent LECs would be quite unlikely to even reach this point. Many LEC long distance carriers must obtain leased transmission lines from other carriers for the bulk of their network services. To the extent that Independent LECs either lease such lines or even simply resell long-distance services provided by others, their ability to charge predatory prices is constrained by the wholesale price charged by the underlying carrier (who may also be an actual or potential competitor).

Competitors will have a number of advantages, including efficient technology, economies of scope with their existing services, the ability to combine their facilities with those obtained from an incumbent LEC on an incremental-cost basis, see generally Interconnection Order, para. 690, and the ability to enter the market quickly by reselling Independents' local exchange and access services. See, e.g., Id., paras. 863-864. They will also be able to put pressure on Independent LEC's local prices because new entrants will be free of many of the regulatory and universal service obligations applicable to LECs. As Professor Spulber explains, the effect of the new Act is to eliminate any alleged barriers to entry and to dispel any notion that the local exchange is still a "natural monopoly." See Statement of Professor Spulber at 31.

Indeed, huge companies operating on a global scale -- most notably AT&T -- have announced plans to provide service in all fifty states. Two days ago, MCI announced that it will soon provide facilities-based switched local service in 13 new markets: Denver, Los Angeles, Memphis, Miami, Minneapolis, Newark (NJ), Orlando, Phoenix, Portland (OR), Raleigh, San Diego, San Francisco and Tampa. Together with the 12 cities previously announced, MCI states that these 25 cities cover 45 percent of the business customers in the U.S. As companies with strong national brands such as AT&T and MCI, as well as the BOCs, offer packages of services in which long distance is only one component, Independent LECs will be faced with a situation in which they will not only be able to raise prices for long-distance services, they will be unable to raise prices for any of their services.

It is true that small Independent LECs are initially exempt from some of the new interconnection obligations, but these exemptions do not constitute immunity from competition. And state regulatory bodies are responsible for determining whether conditions exist to require small LECs to comply with the full panoply of interconnection obligations. See 47 U.S.C. § 251(f). Even under existing regulations, Independent LECs could not effectively cross-subsidize long distance service with local or access revenues. In order to effectively cross-subsidize, an Independent must evade both federal and state regulatory monitoring of access and local exchange service revenues. Additionally, many Independent LECs operate under some form of price regulation which further eliminates incentives to cross-subsidize.[9]

B. Independent LECs Lack the Ability to Exercise Market Power in the Long Distance Market by Discriminating Against Competitors

An Independent LEC cannot successfully discriminate against its competitors in favor of itself. Like successful cost misallocation, successful discrimination would require the LEC to evade the effects of local and long-distance competition, as well as federal and state regulators. A specific concern expressed by the Commission along these lines is that a LEC could somehow discriminate in the quality of interconnection it provides to a competitor, relative to the interconnection it provides itself. See Notice, para. 158. As discussed above, and at length in Professor Spulber's statement, there are no economic incentives to engage in this type of discrimination. See Statement of Professor Spulber, at 32-34. Independent LECs obtain significant revenue from access charges; there is no incentive to risk this revenue in an attempt to gain market share from large, national interexchange carriers. Independent LECs also have no economic incentive to provide competitors with discriminatory access to degrade their quality of service. Just as grocery stores have incentives to maximize revenues by selling national brands along with the "house brand," so do local exchange and access providers have an incentive to maximize revenues by selling the maximum amount of each brand of long-distance service available in their service area. See Statement of Professor Spulber, at 42.

As a general matter, it should be noted that it may not be technically feasible to identify incoming traffic of competitors and selectively provide discriminatory access where shared facilities are used for both local exchange and access. The availability of dedicated access also

[9]GTE, Southern New England Tel., Aliant Communications (formerly Lincoln Tel. Co.), Frontier, and Sprint/Local operate under the FCC's price cap regulation, while Cincinnati Bell operates under the FCC's Optional Incentive Regulation plan. Over 600 Independent LECs charge access rates based on "average schedules," where interstate rates are also not based on individual company costs.

makes such discrimination impossible. Moreover, competition and regulation present a substantial number of barriers to such discrimination. The 1996 Telecommunications Act will increase the availability of competing access services, including resellers, who would respond to any discriminatory access. Additionally, both state and federal regulations prohibit discriminatory access, and numerous standards bodies establish technical standards governing the switching and transport of long-distance telephone calls. The Commission's complaint procedures facilitates third-party monitoring of carrier activities for perceived improprieties.

IV. Dominant Regulation is Unnecessary Given the Absence of Market Power and Would Create Competitive Harm

Application of dominant regulation is premised upon a finding of market power. See, e.g., Notice, para.114. As Independent LECs do not have such market power, dominant carrier regulation is not appropriate. Moreover, dominant regulation of Independent LEC long-distance services would harm the public interest by creating competitive distortions, and discouraging market entry by independent LECs as new competitors, with no attendant benefits.

The Commission acknowledges that dominant carrier regulation is not designed to address the issues of LEC discrimination, e.g., cross-subsidy or inferior access. Notice, para. 132. And, treating LECs as dominant carriers in the interstate long distance market would actually reduce competition in that market in at least three ways: (1) the regulatory burdens would preclude some LECs (particularly small LECs) from entering the market at all[10]; (2) price competition would be reduced because LECs would be forced to reveal their pricing strategy to competitors via the long tariff notice period; and (3) LECs would be discouraged from introducing new long distance services by the cost support and notice requirements. As Professor Spulber explains, asymmetric application of regulations creates distortions of the

[10]Dominant regulation would have a disparate impact on smaller Independent LEC carriers who have traditionally been subject to reduced administrative burdens associated with regulation. See, e.g., 47 C.F.R. § 61.49 (reduced tariff filing requirements for smaller LECs); 47 C.F.R. § 32.11 (reduced accounting requirements for smaller LECs). The increase in regulatory burdens may be sufficient to create insurmountable barriers to entry for many firms.

market, and biases market outcomes in favor of the choices of regulators, not customers. Statement of Professor Spulber, at 50-54. The only result of dominant regulation of Independent LEC long-distance operations would be to protect the non-dominant carriers, including AT&T, from competition and reduce customer choice. Id.[11]

It bears noting that interexchange carriers do not face dominant carrier regulation or separation requirements as they become integrated, facilities-based local and long distance providers. Statement of Professor Spulber, at 30-31. Only recently, the fourth-largest IXC acquired a major provider of local exchange and access services. It is doubtful that this transaction would have occurred if it would have subjected the resulting company to more burdensome regulation. Subjecting an integrated facilities-based local and long distance provider who began as an incumbent local exchange carrier to dominant carrier regulation, while subjecting the same provider who began as a long-distance company to streamlined regulation, or none at all, is irrational. See Statement of Professor Spulber at 52. The FCC elected to rely on market forces and the complaint process to protect against anti-competitive conduct by AT&T (who is rapidly becoming a facilities-integrated wireline and wireless local exchange provider), and other multi-service providers. Requiring facilities-integrated LECs to file tariffs, cost support, and obtain other approvals, discriminates against those LEC providers. The best policy result is to increase competition in the interstate, interexchange marketplace by establishing a level playing field for all providers.

[11]Dominant regulation of integrated LECs would be particularly inappropriate should the Commission adopt its mandatory detariffing policy for non-dominant carriers (which will effectively be all other long-distance providers). Requiring extended notice periods and approval of new service offerings of integrated LEC long-distance providers, but not other providers, will likely lead to the same anti-competitive harms the Commission seeks to address in the Interexchange NPRM. See generally Interexchange NPRM.

V. The Competitive Carrier Separation Requirements for Provision of Interexchange Services by Independent LECs Create Barriers To Entry and Should Be Eliminated

This Notice requests comment on whether the Competitive Carrier separation requirements should be modified or eliminated. Notice, para. 157. Briefly, these separation requirements are that a LEC: 1) maintain separate books of account; 2) not jointly own transmission or switching facilities; 3) obtain any LEC services at tariffed rates.[12]

Eliminating separation requirements for an Independent LEC's interexchange operations presents no risk that Independent LECs will obtain market power in the interstate, interexchange services market. As shown above, LECs have no incentive to engage in such leveraging, neither possess nor could obtain market power in local exchange and exchange access which would permit such leveraging, would not profit from such leveraging, and would not be able to do so under existing cost allocation rules, and other non-discrimination regulations imposed on local exchange operations. USTA discussed the basis for removal of these restrictions at length in its Comments on the Interexchange NPRM, and will not repeat extensive discussion here.[13] Simply put, there are two reasons for elimination of the Competitive Carrier separation requirements: 1) they are unnecessary to protect competition, given the new regulatory regime and changes in the marketplace, and the enormous resources of the other participants in the interexchange market; 2) they create a disparate burden for Independent LECs who will compete for the same customer against larger integrated companies who are subject to no cost allocation or separation requirements.[14]

As Professor Spulber discusses, regulation should recede as competition expands. By eliminating the separation requirements, the Commission can create important efficiency gains in

[12]Fifth Report and Order, 98 FCC 2d at 1198.

[13]See Comments of USTA, CC Docket No. 96-61 (April 19, 1996), at 12.

[14]Competitive Carrier Proceeding, 98 FCC Rcd at 1197-98. (The Commission stated it sought to avoid excessive burdens in establishing conditions for forbearance because such burdens lessen competition and impose costs on consumers).

the interexchange market. Regulation creates administrative costs, which are ultimately borne by residential and business customers. The costs of regulation are also reflected in reduced consumer choice, and reduced innovation, which result when market competition is impeded. See Statement of Professor Spulber at 55-56. Thus, the Competitive Carrier separation requirements should be removed, in order to create efficiency gains in the interexchange market and bring consumers further benefits of competition.

Because the separation requirements preclude Independent LECs from exercising economies of scope available to other firms jointly providing local and long-distance service, they face a higher cost hurdle in determining whether to enter the market than would a firm in a competitive market. Thus, the separation requirements distort market decisions and deter some Independent LECs from providing long-distance services. See Statement of Professor Spulber at 53. In particular, the prohibition against the joint ownership of switching and transmission facilities creates a competitive disadvantage against other firms who are permitted such joint ownership simply because they purchased their local exchange facilities, rather than undertake the initial risk of the sunk costs associated with constructing their own.

This disparate burden will only become a more pronounced handicap to the Independent LECs in the future. All other segments of the telecommunications industry, e.g., wireless providers, cable television providers, and interexchange providers, are upgrading facilities and planning to use those facilities for both local exchange, exchange access, and interexchange services. See Business Week, April 8,1996, at 72 ("AT&T intends to be the premier deliverer of a full range of services," quoting Chairman Robert Allen). The effect of disparate regulation of Independent LECs is therefore not only to impede Independent LEC entry into the long-distance market, but into the related product market associated with the future of the telecommunications industry - a market of single-source providers of multiple services.

At the same time, in a few areas of the country, the future is not arriving as quickly. In those areas, AT&T is still the only provider of interstate long distance service. The benefits of increased competition in the long distance market have bypassed consumers in these areas. The notable reluctance of IXCs to enter these markets voluntarily has precluded the availability of competitive alternatives, leaving the LECs in these areas as virtually the only potential providers of competitive long distance service. Removal of the separation requirements will also serve the public interest in those areas. To the extent that the FCC can streamline its regulatory framework to encourage for these LECs to offer interstate, interexchange services, customers in these rural areas could experience long distance competition for the first time. A competitive communications system is a more efficient system. Consistent with its mandate to bring the benefits of a nation-wide, efficient communications system to all the people of the United States, the Commission should level the playing field for all providers of communications services.

CONCLUSION

The Commission should determine that Independent LECs cannot exercise market power to harm competition in the interstate, domestic, interexchange services market, or in the market for integrated local and long-distance services, and eliminate the separation requirements adopted in the Competitive Carrier proceeding, consistent with the facts and analysis provided herein.

Respectfully submitted,

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Statement of Daniel F. Spulber
Northwestern University

My name is Daniel F. Spulber. I am the Thomas G. Ayers Professor of Energy Resource Management and Professor of Management Strategy at the J.L. Kellogg Graduate School of Management, Northwestern University, where I have taught since July, 1990. I received my B.A. in Economics from the University of Michigan, and my M.A. and Ph.D. in Economics from Northwestern University. Before joining the faculty of Northwestern University, I was Professor of Economics and Professor of Economics and Law at the University of Southern California. I have also taught economics at Brown University and the California Institute of Technology.

I have been ranked 6th in the United States in the listing of top 50 economists by pages published in leading journals, 1984-1993, "Trends in Rankings of Economics Departments in the U.S.: An Update, Loren C. Scott and Peter M. Mitias, *Economic Inquiry*, v. XXXIV, April, 1996, pp. 378-400.

I have conducted extensive research over the last eighteen years in the areas of regulation, industrial organization, microeconomic theory, and energy economics. In my scholarly research and consulting work, I have studied issues of regulation and competition in network industries, including telecommunications. I am the author of author of *Protecting Competition from the Postal Monopoly*, with J. Gregory Sidak, published in 1996 by the American Enterprise Institute, *Regulation and Markets* published in 1989 by M.I.T. Press, and coeditor of *Essays in the Economics of Renewable Resources*, with Leonard J. Mirman, published in 1982 by Elsevier-North Holland. I have published over 50 articles on regulation, pricing and related topics in numerous academic journals, including the *Yale Journal on Regulation*, the *New York University Law Review*, the *Journal of Economic Theory*, the *Quarterly Journal of Economics*, the *Rand Journal of Economics*, *The Review of Economic Studies*, and the *American Economic Review*. I am the founding editor of the *Journal of Economics & Management Strategy*, published by MIT Press.

I have been asked by the United States Telephone Association to conduct an economic analysis concerning independent local exchange carrier ("LEC") issues pertaining to the question of whether or not the independent LECs should be considered non-dominant in offering interLATA telecommunications services and pertaining to the structural separation safeguards applied to these companies by the Federal Communications Commission (FCC). In my statement, I respond to some of the questions posed in the FCC's NPRM (CC Docket No. 96-149).

Based on my economic analysis, my conclusions are as follows:

(1) The independent LECs should not be classified as dominant carriers in offering interstate, domestic, interexchange telecommunications services (hereafter interexchange services).

(2) The protections afforded by the separate affiliate safeguards are rendered unnecessary by competition in interexchange services and in the local exchange. Moreover, the protections themselves serve as competition-reducing entry barriers and therefore should be eliminated.

My statement is outlined as follows. In Section I, I begin by examining the question of whether or not the market power of the independent LECs supports elimination of "separate affiliate" safeguards and classification of independent LECs as non-dominant carriers. I show that the relevant product market is interstate, domestic, interexchange telecommunications service and the relevant geographic market is national in scope. I further consider the independent LEC's market share in interexchange telecommunications, the demand and supply elasticities in interexchange telecommunications, and the cost structure, size and resources of the independent LECs. In Section II, I consider the impact of competition in the local exchange to determine whether or not the independent LECs have the opportunity or the incentive to leverage market power through "raising rivals' costs" or cross subsidization of interexchange telecommunication. I emphasize that local exchange telecommunications no longer is a natural monopoly and that barriers to entry into local telecommunications have fallen or been significantly reduced. I show that the independent LECs have no economic incentive or opportunity to engage in monopoly leveraging, "raising rivals' costs," or cross subsidization. Finally, in Section III, I explain why the separation and dominant-carrier regulations create barriers to entry into interexchange telecommunications, thereby impeding competition, particularly because they are asymmetrically applied.

I. Economic Analysis of Telecommunications Markets Supports Elimination of "Separate Affiliate" Safeguards and Classification of Independent LECs as Non-Dominant Carriers

The Commission defines "dominance" as having market power. Market power is said to arise when a firm is able profitably to raise its price substantially above the competitive level, or to raise market prices by restricting their output.[1] The Commission's Fourth Report and Order cites the Areeda and Turner definition of market power as "the ability to raise prices by restricting output" and the Landes and Posner definition of market power as "the ability to raise and maintain prices above the competitive level without driving away so many customers as to make the increase unprofitable."[2] By these, or any other reasonable definition, the market power of the independent LECs in interexchange telecommunications is negligible. Therefore, the independent LECs should not be classified as dominant carriers in interexchange telecommunications. In the next section, I examine the question of the independent LEC's market power in the local exchange and whether or not this results in the incentive or opportunity to engage in monopoly leveraging in interexchange telecommunications.

A. The Relevant Market is the Entire U.S. Interstate Telecommunications Market

Determination of market power includes both demand and supply responses to the firm's price change, including potential entry. A firm's ability to raise its price profitably depends on the extent to which the firm's customers reduce their purchases as a result, which is the own-price

[1] While practically every firm has some market power, due to market frictions such as transaction costs and transportation costs, empirical tests for market power generally specify some threshold level, such as a 5% or 10% increase over the competitive price. The empirical test also must make a determination of the estimated competitive price for the relevant market.

[2] See the discussion in FCC 95-427, In the Matter of Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, at 5.

elasticity of the firm's demand. The price responsiveness of the firm's demand depends in part on the substitutes available to the firm's customers. In addition, it depends on the reactions of the firm's competitors, as they alter their prices, product offerings, sales and marketing efforts, and amount of services sold. In addition, it is essential to take into account not only the supply response of the firm's existing competitors, but also the supply responses of new entrants that could be attracted to enter by the prospect of higher prices.

To evaluate market power, thus requires a definition of the firm's relevant product and geographic market. The product and geographic market definition should be sufficient to identify the demand and supply responses to the firm's pricing decisions. Excessively narrow definitions that overlook such responses would incorrectly overstate the firm's degree of market power and bias the relevant policy.

I agree with the present NPRM's tentative conclusion (¶ 119) that for the independent LECs, "all interstate, domestic, interexchange telecommunications services as the relevant product market." By this I mean that for a given customer the product market is a service that allows the customer to reach all other interstate, domestic, inter-exchange locations. I am not addressing distinctions between different ways in which the services are offered. I further agree with the tentative conclusion reached in the Interexchange NPRM (¶¶ 51-52) that the Commission should continue to treat "interstate, interexchange services as a single national market when examining whether a carrier or group of carriers acting together has market power." However, I do not agree with the present NPRM's tentative conclusion (¶ 126) that the Commission should "evaluate an independent LEC's point-to-point markets in which calls originate in its local exchange areas separately from its markets in which calls originate outside those areas, for the purpose of determining whether an independent LEC possesses market power in the provision of in-region, interstate, domestic, interexchange services." The Commission has consistently found interstate, domestic, interexchange services to be the relevant market for determining dominance. This was the standard applied to AT&T,[3] and any departure for the purposes of evaluating market power of the independent LECs in this market would be inconsistent and would bias the results. The Commission in its Fourth Report and Order defined a "single national relevant geographic market (including Alaska, Hawaii, Puerto Rico, U.S. Virgin Islands, and other U.S. offshore points) as the relevant geographic market, and applied the same standard to AT&T.[4] Again, any departure from this standard for the purpose of evaluating market power of the LECs in this market would be inconsistent and would bias the results, as well as being economically incorrect.

To summarize, the economically proper product market definition, for purposes of evaluating market power, should be all interstate, domestic, interexchange services and the geographic market definition should be national in scope. There are several determinative economic reasons for these conclusions.

All interstate, domestic, interexchange telecommunications services are the relevant product market because such services generally are sold together. A customer of an interexchange carrier purchases all domestic service to any location as one service, not a la carte. Services are not sold on a point-to-point basis, but rather, a customer is able to call all locations. Thus, such services almost always appear as a bundle, so that, unbundling them conceptually would depart from the way the services are both sold and purchased. As a consequence, companies compete by offering complete services and schedules of prices for the overall service. Customers usually choose a single carrier for their entire interexchange service rather than purchasing narrower product services from multiple carriers simultaneously. A market power test

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[3] FCC 95-427, In the Matter of Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier.

[4] FCC 95-427, at 9.

that failed to recognize the one-stop-shopping nature of interexchange services would be expected to yield incorrect results.

The geographic market definition should be national in scope because the major carriers, including AT&T, MCI and Sprint, compete nationally offering services that originate at all points and terminate at all points. Their service offerings are ubiquitous, not local or regional. Their facilities consist of national networks. Competition between these companies, therefore, takes the form of competition between national networks. Marketing and sales efforts of these companies are national in scope. Pricing programs and promotions are national as well. Limited geographic market definitions, such as "point-to-point" markets, are inappropriate. Services are not offered on such a point-to-point basis. To restrict the geographic market definition to anything less than a national definition (say a regional or local basis) would fail to account for the nature of the ubiquity, product offerings, pricing, facilities, and competition in this marketplace.

The LECs provide local exchange services that are regional or local in geographic scope. This does not imply in any way that their sale of long distance services departs from the national geographic market definition. Customers of the LECs can choose between the long distance services of national, regional or local providers of long distance services. The LECs ability to raise the price of telecommunications services will be constrained by the prices offered by the national carriers and any other carriers offering long distance services. To narrowly define markets by region or locality would misrepresent the extent of the competitive activities of the long distance carriers and thus present an inaccurate picture of the competitive alternatives available to the customers of the LECs. Thus, incorrectly narrowing the product or geographic market definition reduces the applicability of the market power test.

Geographic market definitions can sometimes be appropriate when transportation costs are significant. Transportation costs can limit customer choices in some types of markets, such as restaurants, when customers must travel to the firm's location. Transportation costs can also be a factor in some markets, such as cement, when firms transport their products and transportation costs are a significant share of the market value of the good. These considerations may apply to some extent in long distance telecommunications. There are costs to providing a point of presence for long distance carriers. However, these costs already have been incurred by the national carriers, in most locations. Therefore, at those locations, service is almost universally available and customer transportation costs are not an issue, since customers have access to all carriers through their local exchange, through competitive access providers, or other access providers such as wireless companies. There is no problem of travelling to reach a firm that is "far away." All carriers that serve the area are available at the customers location, the local transport costs of the carriers do not differ greatly.

Therefore, the pricing of interexchange services of the independent LECs is constrained by competition from national, regional and local providers of interexchange services. The pricing of interexchange services is constrained by competitive product offerings that consist of interstate, domestic, interexchange telecommunications services. Moreover, the services offered by the independent LECs compete with services provided by carriers that operate in the national market for interstate, interexchange services.

B. Market Share in Interexchange Telecommunications

Having established the definitions of the product and geographic markets, is apparent that the market shares of the independent LECs in interexchange telecommunications are very small. Market shares alone do not determine market power. Thus, even a high market share in an industry with low barriers to entry, opportunities for product differentiation, or ongoing technological change, does not necessarily confer market power. The firm's market share does not yield market power because entrants can take away customers with lower prices, differentiated products, or product innovations. However, while a high market share is not sufficient to indicate market power, a market share that is very low or even negligible is sufficient to indicate the absence of market power.

Table 1 lists the market shares of the interexchange long distance carriers as of the first quarter of 1996. The four largest national carriers (AT&T, MCI, Sprint, and LDDS Worldcom) have over 85% of the market. Market shares of other individual companies drop off dramatically. Next, for example, is Frontier Companies with a 1.9% market share and Cable and Wireless Communications, Inc. with a 1% market share, while all other companies have shares *below 1% of the market.* These minuscule shares cannot be consistent with a "dominant carrier" classification. Moreover, if the largest carrier, AT&T Communications, is nondominant with 53% of the market, surely smaller carriers, including the independent LECs with market shares less than one hundredth those of AT&T, cannot be classified as dominant. This much is a matter of common sense.